

Internal Revenue Service

memorandum

CC:TL:TS
TSANDERSON

date: **AUG 9 1988**

to: District Counsel, Chicago MW:CHI
ATTN: David L. Zoss

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This memorandum responds to your request for technical advice concerning the above-referenced case.

ISSUE

Whether the gain or loss from the disposition of physical commodities by the petitioner in [REDACTED] and [REDACTED] should be characterized as ordinary or capital.

CONCLUSION

Gain or loss on the disposition of physicals under the facts of this case should be characterized as capital since the petitioner was a trader.

DISCUSSION

The primary issue in the case is whether physical commodities held by the petitioner in [REDACTED] and [REDACTED] were ordinary income assets pursuant to I.R.C. § 1221(1). Essential to this analysis is the determination of whether petitioner's activities are those of a "trader" or a "dealer." The petitioner was a trader in futures contracts.

During the years at issue the petitioner conducted a "[REDACTED]" type of trading strategy on the [REDACTED] (Exchange). 1/ All, or substantially all, of the

1/ This memorandum relies on the facts as presented in your memorandum and attachments of May 3, 1988; subsequent telephone conversations, and the petitioner's settlement proposal of [REDACTED].

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petitioner's physical positions were acquired by taking delivery under long futures contracts and disposed of by making delivery under short futures contracts. Delivery was accomplished through the Exchange by delivering the warehouse receipt representing title to the physical. Under Exchange procedures, the Exchange [REDACTED] assigns deliveries to holders of open long positions in the order in which the long contracts were entered into.

Once it is determined that a person is a trader, all the gains from its activity as a trader are capital. See Farroll v. Jarecki, 231 F.2d 281 (7th Cir. 1956); Commissioner v. Covington, 120 F.2d 768 (5th Cir. 1941); Kemon v. Commissioner, 16 T.C. 1026 (1951). The Service's position is that the holding of physical commodities in a manner such as that by the petitioner, who was a trader, is the holding of capital assets. 2/ See Wood v. Commissioner, 16 T.C. 213 (1951); Seroussi v. Commissioner, T.C. Memo. 1963-233. The significant point under the facts of this case is that all, or substantially all, of the physical positions were disposed of by delivery of the warehouse receipts, under a short position, through the Exchange. See Kemon v. Commissioner, supra at 1032-33 (status of sellers of securities on an exchange as to the source of supply is not significantly different from that of those to whom they sell; securities traded on an exchange are as accessible to one as the other and the seller performs no services that need to be compensated by a mark-up).

2/ The Service took the position in King v. Commissioner, 89 T.C. 327 (1987), that gains from transactions in physicals similar to the above should be ordinary. The position was taken in the alternative to the primary position that the interest incurred with respect to the physicals should be subject to the investment interest limitation of I.R.C. § 163(d). At the time the Service took the position concerning character of physical gains, it was thought that this was an aggressive position with significant hazards. The Court decided against the Service on the investment interest issue. The Court did not address the alternative argument. The Service will no longer take this position in cases similar to King.

CONCLUSION

Pursuant to the discussion above, this issue should not be litigated on these facts. This conclusion has been discussed with David Zoss who agrees.

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